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RETIREMENT REFORM REVISITED

EXECUTIVE SUMMARY: Retirement fund reform will affect us all. In this article Christo Terblanche shares some insights on the current proposals and the complicated debates taking place. In the coming editions of Quarterly Commentary we plan to tackle some of the issues in more depth and, where appropriate, give you our views on them. We do not anticipate a speedy resolution to the process.

Retirement fund reform is a complex topic

Retirement fund reform refers to the way the retirement system in South Africa is being changed. This process began more than 10 years ago with a series of reviews of the tax system and is now firmly in the spotlight as stakeholders try to bed down the best way forward. Broadly speaking, the changes aim to increase participation of all South Africans in the financial system (through an increase in savings) and provide a social security net for the vulnerable and poor.

The range of objectives policymakers aim to meet is diverse, and includes:

- Poverty alleviation
- Increasing savings
- Limiting the impact on the state's purse
- Increasing public confidence in the retirement fund system
- Capital market stability
- Labour market incentives

These are all hefty topics in their own right. It is no surprise therefore that it is a complicated, sensitive and politically charged subject.

Consultative processes take time and there are divergent views on many issues

It has taken some time to get to the stage in the process where there is coordination (but not necessarily consensus views) between government departments on the various issues. There are also many other groups involved in the process with vested interests and differing views.

An overview of the current proposals and issues: Proposed pillar one – social security

The first proposed level (or pillar as they are also referred to) is about making sure there is a safety net for everyone. It is intended to be a public grant system to deal with poverty. You will not have to contribute directly to this – the state will fund this out of tax revenues. It is proposed that everyone will get access to three basic social grants: an income grant, child support grant and old age pension.

There is some interplay between this level and the next, which covers compulsory retirement saving. Depending on the level of the state old age pension, it either increases or decreases the level of importance of the next pillar: the funded element.

Current debates about social security:

There is broad consensus on some issues, but there are some difficult decisions still to be made.

1. **Basic income grant:** Should any social security system extend benefits to include a basic income grant that provides a minimum level of income to all adult citizens?
2. **Means-testing to qualify for the state old age pension:** An example of an issue where there is broad consensus is that the basic state old age pension should no longer be means-tested. The reason for this is that if you are on the margin between qualifying for this and not, there is a perverse incentive to spend more so that you make sure you qualify. To make sure that you get rid of these incentives, it is generally agreed that everybody should get the basic state old age pension. Even the wealthy.

Proposed pillar two – mandatory saving for retirement together with mandatory risk insurance (life and disability)

A lot of the debate is about the compulsory retirement savings level or pillar of the proposed new retirement system. This level is about establishing a 'mega' government fund called the National Social Security Fund (NSSF). Every employed person will have to contribute a percentage of his or her salary to this fund.

It is not completely clear how many people will be covered in each level. If the limit for mandatory contributions before individuals can opt out is R150K, how many people will qualify? Alexander Forbes estimates that only one million people in South Africa earn more than R150K. This means that potentially only one million people will be investing in retirement products outside the mandatory fund space.

Proposed pillar three – voluntary savings

Pillar three is similar to the current retirement annuity fund world, where individuals may choose to contribute to and build up retirement savings in addition to any employer-based retirement funding arrangement.

Benefits at retirement: compulsory pensions

Regarding what you get at retirement (the so called 'benefit' stage) – there is a big push towards requiring everyone to take out an annuity with no ability to withdraw a lump sum at retirement. The key question is whether one will be forced to buy a guaranteed annuity (a conventional pension) or whether one will be given the choice to invest in an investment-linked annuity (a living annuity). A conventional annuity requirement is likely to prejudice poorer people as the richer tend to live (and hence draw pensions) for longer than the poor.

Current debates about mandatory retirement savings:

1. **Tax:** An approach consistent with the current retirement funding system would be a tax deduction going into the fund, i.e. pre-tax income, with no tax paid in the fund, and tax being levied on income received on the payments out of the fund in retirement.
2. **Compulsion:** There is general agreement that it should be compulsory for all in formal employment to contribute.
3. **Level of contribution:** This debate is about the absolute level you should contribute, e.g. 15% of your salary. It also questions how much income this contribution should be based on – is it on your first R60K that you have to make a contribution on, or your first R150K, or could it be a higher level?
4. **Preservation:** It is largely agreed that you will have to preserve your existing benefits and you will not be able to cash in your savings early – but this is not without controversy. People whose circumstances change (e.g. when they lose their jobs) need their money to survive today.
5. **Role of the private sector and government:** There is a lot of debate about who should administer the scheme.
6. **Fund design issues:** How will it be funded, will benefits be defined benefit (DB) or defined contribution (DC)?
7. **Risk benefits:** It is largely agreed that there will be compulsory risk benefits in the structure. It is not agreed how much of your contribution will go to providing risk benefits versus how much will go into retirement savings. Government is making a strong argument that no matter what happens, even if you are allowed choice on the investment side, you will not be allowed choice on the risk benefits side.
8. **Extending the reach of the system to the informal sector:** If you are not formally employed you are not caught in the net at all. Chile also has a large informal work force and when they introduced a mandatory system it was hoped that eventually all those from the informal sector would see the benefits of the scheme and move into the formal sector. But it turned out to have the opposite effect – people left the formal sector because they wanted to avoid the compulsory fund, which they saw as tantamount to losing control over their savings.
9. **Issues around investment management mandates:** There is a general view that investment management will be outsourced to the private sector, but this is not uniformly held. Another debate is around the extent to which choice of underlying investment options will be made available.
10. **Opting out of the NSSF:** There are issues around opting out and what scheme you can use instead. While there is an argument about economies of scale reducing the cost, there is also an argument for the role of competition in driving efficiencies. A possible outcome is high hurdles for size of scheme, possibly with lower levels required for closed funds (e.g. corporate retirement funds) than for open funds.
11. **Costs:** Will costs be regulated or will competition be allowed with rules on effective disclosure and transparency (as in the unit trust industry)?

The role of consistency in creating public confidence

Once design issues are resolved and the debates are over, a consistent approach is required to maintain and build public confidence in the retirement fund system over the long term. Some reassurance has been given to members of existing schemes, who were concerned about whether their existing savings would be transferred to the NSSF to their detriment.

In conclusion: the reforms will grow the savings pool… or will they?

Our role in the industry may change under these proposals as a larger number of individuals will be required to save for retirement. The potential growth in savings will be very good for the economy which is starved of domestic savings.

There is a caveat to this. One of the design issues currently being debated is how the NSSF scheme will be funded: should it be what is called 'pay as you go' (PAYG), or will it be a funded system? If it is PAYG, there is little if no increase in savings. We will address this debate in a future issue of the Quarterly Commentary.

While we are supportive of the broad objectives of retirement reform, we caution that the devil is likely to be in the detail.

Current debates about voluntary savings:

Should there be a tax incentive, and if so, up to what level?
Right now you can get a tax break on up to 15% of your (non-retirement funding) income, with no upper limit and no compulsion (requirement to do so). It is very likely that in the new regime an upper limit will be applied beyond which no tax break will be available.

An overview of retirement fund reform:

A. Who is involved?
It is a consultative process involving a number of different groups. They include:

1. **The National Treasury** – which wishes to ensure that there is `transparency, accountability and sound financial controls in the management of public finances'.
2. **The Department of Social Development** – which wishes to ensure that South Africans 'have access to comprehensive, integrated, sustainable and quality social-development services to combat vulnerability and poverty'.
3. **The private sector:**
   a. Employers – who are currently sponsors of the majority of retirement funds and have a strong interest in ensuring that their employees are adequately catered for.
   b. The financial sector – which has a vested interest in encouraging members to save more for retirement and which wishes to play a role in administration and management.
4. **Organised labour** (e.g. COSATU).
5. **Regulators** (e.g. the Financial Services Board).

B. Why the change?

1. **To get more people to save for their retirement – grow savings.**
   In South Africa, one cannot assume everyone has enough money to put some aside to look after themselves as they get old and retire. High unemployment levels, extent of poverty and the impact of HIV are all factors that affect this.
   Financial literacy and the structure of the informal (and currently 'excluded') sector are also factors that affect the debate about any reform to increase savings. Even for those currently employed, the impact of a proportion of one's wage being put away for 'later' on both labour and the private sector is significant.
2. **To enable more people to maintain their standard of living when they retire.**
   Factors that affect how much your retirement income will replace your salary or earnings include:
   a. How much money you put in
   b. How much money is eaten away by costs
   c. How much your money grows
   d. How long you save
   e. How much you take out and when

3. **To reduce the extent to which people take money out of their retirement savings to spend on current needs.** The most significant time that people tend to erode their retirement savings is when they change jobs and make early withdrawals. People need to be encouraged to preserve their benefits and stay invested for longer. On the other hand, there are vast numbers of people who need this money to simply survive and stay above the breadline, so a balanced approach is required.

C. What principles underpin the change?

Equity:
- People's differing abilities to contribute to be taken into account

Mandatory participation/compulsion:
- Based on the belief that people do not and will not save enough if left up to them
- Increase scale, reduce cost
- Increase coverage

Efficiency of the system:
- Scale will help achieve this
- There is still uncertainty about the roles of government and private sector in achieving this

Solidarity:
- With context of equity and different people's abilities to pay, it is acknowledged that the design of the system must allow some degree of cross-subsidy of the poor by the rich